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Evolving LDC Debt Crisis

National Intelligence Council
Memorandum

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National Intelligence Council
Memorandum

This Memorandum was coordinated within the National Intelligence Council and with the Directorate of Intelligence. Comments are welcome and should be addressed to the [redacted] 25X1
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Evolving LDC Debt Crisis

Scope Note

Many observers believe the debt crisis in less developed countries (LDCs) will persist for many more years. This Memorandum, however, argues that strong market forces are accelerating the corrective process and thus greatly deepening the painful consequences over the next six months to a year.

In the midst of each global economic crisis in the past 10 years, a broad spectrum of observers predicted that the problems and their devastating impact would be virtually permanent. For example, many journalists, politicians, and economists forecasted that the 1973 shortages of food and industrial raw materials would be long lasting, the dollar would continue to sag for the foreseeable future (1978), and, most notably, the price of oil would rise sharply for decades (1973-74, 1979-80). Although these dire warnings played a useful role in galvanizing the public support needed to cope with the emergency, they tended to obfuscate analysis of the powerful and painful reactive pressures that were forcing a correction of the original problem. This misdiagnosis in part was caused by the lack of experience in dealing with the particular crisis at hand—nearly all crises arise from a unique set of circumstances—and by the absence of data indicating that changes were under way until long after the fact.

There now is developing a similar environment of misunderstanding about the market forces at work in regard to the LDC debt crisis. As such, this paper steps back and looks at the unfolding process forced by the debt crisis, paying special attention to the role of short-term capital movements and their policy implications. This discussion relates only to key LDCs in serious financial trouble because of sizable commercial debts—Argentina, Brazil, Chile, Mexico, and Venezuela. A large number of less advanced LDCs, such as Bolivia, Ghana and Zaire, face severe financial straits, but their difficulties reflect mainly economic mismanagement or political turmoil rather than debt-related problems. Moreover, the effort concentrates on the shorter term aspects of the evolving crisis and therefore excludes the medium and longer term political and economic influences.

Evolving LDC Debt Crisis

Key Judgments

The debt crisis in less developed countries has triggered a corrective and painful process that now is moving faster than most observers had expected. Most notably, the strong market reaction to the inability of key LDCs to meet their foreign financial obligations has led to a dramatic and unprecedented decline in imports of the five key debt-laden LDCs[1]—from 35 percent to 75 percent from their 1980 or 1981 peaks. In fact, imports dropped much more suddenly and deeper than planned under government import restraint programs mainly because of a substantial loss of short-term capital, especially trade credits. As a result, there have been serious disruptions in domestic economic activities in these five countries and a considerable reduction in living standards.

The sharp decline in imports and falloff in economic activity has set the stage for the key LDCs to achieve a "v" shape rather than gradual "u" shape adjustment to the debt crisis:

- Their current account position already has improved to the point where, with normal direct investment and trade credit flows, they would need little or no net new loans from commercial banks.
- They could reach a payments position by 1984 that does not unduly constrain economic growth. Their exports are likely to expand through the remainder of 1983 and gain momentum in 1984 reflecting the industrial-country recovery. This should allow imports to grow at near the same pace as exports, thus maintaining a solid current account position.
- Although the momentum of the domestic recovery may not bring the economy back to its earlier peak level for many months, it would help reinforce confidence in the country's economic abilities and heighten expectations about future gains.
- Once confidence in the foreign financial condition of these LDCs begins to build, foreign direct investment and supplier credit flows should move toward a normal level, giving a one-time boost to the financial recovery process.

[1] Argentina, Brazil, Chile, Mexico, and Venezuela.

[redacted]

- The timing of the recovery is likely to vary among the five key LDCs, with Mexico now having the best chance for rebounding the soonest and fastest.

This favorable prognosis would obviously be adversely affected in all LDCs in the unlikely event that another industrial-country recession occurs during the adjustment period. The process could also be sidetracked in individual LDCs if any one of them had to cope with a prolonged domestic political upheaval.

A much more likely situation that could cause a painful, but temporary, delay in the adjustment process would be a greatly increased liquidity problem sparked by a worsening of creditor confidence. At the present time, current account gains are being offset by a continuing short-term capital drain (although at a lower rate than took place just after the debt crisis began in August 1982). Creditors still fear that any new short-term trade credits would not be repaid, and foreign and domestic investors continue to feel safer with more funds outside the key LDCs. This lack of confidence persists in part because of worries that political upheavals might be ignited by the current widespread economic austerity. Whatever the cause of the short-term capital drain, the resulting liquidity problems would lead to a further reduction in LDC imports (and a corresponding slide in industrial-country exports) and to increased austerity. This influence in turn would have an adverse impact on already-depressed domestic investment. Although the additional economic hardships cannot be translated into political consequences with any degree of certainty, it seems that, at a minumum, the result would be heightened nationalism with anti–First World overtones and, at a maximum, new regimes taking actions, such as an indeterminate debt moratorium, that could seriously hurt US interests.

Thus, a key policy problem facing industrial-country officials in the next six months or so will be how to provide sufficient liquidity to ensure that the ongoing adjustment process continues as smoothly as possible. Several possible options exist, such as a substantial increase in trade credits guaranteed by industrial countries and the establishment of a "safety" fund large enough to convince creditors that a particular LDC will have sufficient foreign exchange to meet its foreign exchange obligations. Each of these schemes has drawbacks in terms of its financial costs and of the possibility that the additional money would go to bailing out those with assets tied up in the LDCs rather than helping the LDCs with their liquidity crisis.

Evolving LDC Debt Crisis

Prelude to Crisis

As part of the normal economic development process, less developed countries (LDCs) are constantly coping with foreign debt-related problems. Although these difficulties always become more severe when the global economy falters, this time a confluence of unusual and unexpected circumstances created a debt crisis. There was an oil price jolt, a sudden and substantial increase in real interest rates, a longer and deeper industrial-country recession than expected, and an unforeseen shift in the oil price outlook, from steadily increasing to declining or stagnating.

When oil-importing LDCs faced soaring oil prices in 1973-74, they were able to ride out the difficulties by borrowing huge sums, in large part because interest rates remained below inflation rates. These negative real interest rates provided a large transfer of income from the savers—mainly OPEC members and those in the industrial world—to the borrowers. The result was that the LDC debt-servicing burden never became particularly onerous. In contrast, when oil prices tripled in 1979-80, these same LDCs had to borrow at interest rates that far exceeded even the high pace of inflation. As a consequence, while the burden of repaying principal (as measured against exports of goods and services) did not increase to any great extent as borrowing climbed, interest payments did. The post-1979 interest rate burden turned out to be double that of the 1970s. The key oil-importing LDCs reacted to the growing financial bind by cutting imports and taking other measures to conserve foreign exchange. In fact, they acted more swiftly and decisively than they did in the aftermath of the 1973-74 oil price rise. These key countries might even have avoided severe debt problems if the global recession had not turned out to be so long and deep.

The oil-exporting countries also faced higher real interest rates on their burgeoning debts. In addition, they were caught by surprise when oil prices declined. Governments in many oil-exporting nations quickly found they could no longer afford the rapidly growing economic development outlays they had planned based on rising oil prices. In 1981 and 1982, both oil-exporting and oil-importing LDCs were forced to borrow large sums on a short-term basis just to maintain economic growth at a reduced pace and to service their foreign debt. With a global economic recovery not yet in sight, and the loss of confidence arising from the earlier Polish and Argentine serious debt problems, the growing reliance on short-term debt could not continue for long, and the stage was set for the debt crisis.

The Evolving Process

Mexico's failure in August 1982 to meet its foreign debt obligations triggered a crisis that had been building for months. At the same time, the jolt greatly accelerated the adjustment process that allows the key LDCs to achieve again a foreign financial position that does not unduly restrain economic growth. That process is likely to move through four stages:

- Initial shock.
- Debtors and lenders clash over the division of the adjustment burden.
- Financial confidence begins to be reestablished and LDC economic recovery starts.
- Manageable foreign financial positions are restored.

These stages will overlap considerably. Their timing will vary among countries and will depend heavily on the pace of economic recovery in the industrial world.

The Initial Shock

Most experts have long believed that a major financial disruption in either Mexico or Brazil, with their huge debts, would severely strain the international financial system and have adverse economic consequences for both LDCs and industrial countries. They were correct. The Mexican problem spread rapidly to other debt-laden LDCs as commercial lenders sharply reduced medium-term lending, refused to extend short-

term credits, and drew down deposits they held in LDC banks. Those with assets in the affected LDCs tried to move as much capital as possible to safehaven countries. The errors and omissions account of the US balance of payments provides a good indicator of these large short-term outflows. It showed an unprecedented $12 billion inflow from Latin American countries in the third quarter of 1982. Meanwhile, the foreign exchange shortages in the affected LDCs forced a sharp cutback in imports and a subsequent decline in domestic economic activity.

A global financial panic was averted mainly as a result of the quick action of the United States and other industrial countries to shore up the foreign positions of Mexico and several other key LDC debtors. These emergency steps helped sustain confidence in the ability of the international financial system to withstand shocks. Although the international financial "safety net" was in some jeopardy, most market participants apparently continued to believe that the industrial countries would take whatever steps were necessary to avoid a disastrous unraveling of the international financial system. The falling US interest rates at the time also provided some glimmer of hope for the future.

During phase I a number of changes took place that helped make the problem more manageable for the future:

- Industrial-country leaders became acutely aware of the impact of the LDC debt plight on their own well-being—reduced exports, financial chaos, and, for the United States, increased migration from Mexico.

- They learned that a crucial aspect of handling the world debt crisis is cooperation among the governments of the industrial world and LDCs, commercial banks, and the IMF.

- Borrowing nations have for the most part accepted the fact that under any circumstances they face a period of austerity; thus, the best they can do is to minimize the pain by negotiating debt settlements with lenders, which provide some increased foreign funds.

Table 1
Key LDCs: Imports (c.i.f.)

	Billion Dollars at Annual Rates		Percent Decline
	Record Level	Expected Low Point	
Argentina	10.5 (1980)	4.8 (1982 III)	54
Brazil	25.0 (1980)	16.0 (1983 II)	36
Chile	6.4 (1981)	2.4 (1983 I)	62
Mexico	24.1 (1981)	6.0 (1983 I)	75
Venezuela	13.1 (1981)	6.7 (1983 II)	49

- Imports by the debt-restrained LDCs fell dramatically—from some 35 percent to 75 percent from record highs set in 1980-81. (See table 1 and inset.) In contrast, countries coping with serious foreign financial difficulties in the previous 25 years typically faced a 20- to 30-percent decline in imports.

The initial emergency phase can be considered to have ended at the close of 1982 or early 1983 when most key LDCs signed debt-relief agreements with the IMF.

Debtors and Lenders Clash Over Division of the Adjustment Burden

In the current phase, both debtor and lending nations are dealing with the grueling task of dividing up the political and economic costs of overcoming the financial difficulties. Major Latin American LDCs are now walking a tightrope between the need to impose more austerity and the political unrest too much austerity will cause. Banks remain highly vulnerable to reduced profits and possible losses over this period. Each side is trying to shift the burdens involved to the other, and both are applying pressure on the industrial-country governments and the IMF to provide more relief.

Negotiations will be arduous and seemingly endless. During this process, most LDCs will become politically unable or unwilling to meet the financial and

economic goals agreed to in IMF rescue packages, and new targets will have to be negotiated—perhaps several times.

Despite these highly publicized difficulties, dramatic improvements in the fundamental foreign financial position of key LDCs have taken place and further gains are expected. The initial financial shock cut imports sharply and stretched out the debt-service burden significantly. The recently agreed-to IMF adjustment programs are helping sustain these large gains and are providing some additional foreign funds. Further relief from the scheduled debt-payment burden facing LDCs seems likely as a result of ongoing negotiations to seek a repayment schedule that "reasonably" accommodates the needs of both lender and borrower. Moreover, key LDC exports have begun to rebound (or at least bottom out) as a result of the economic recovery in the industrial world and of exchange rate changes that are making LDC goods and services more price competitive. Because LDC export revival tends to lag industrial-world economic recovery, it will take up to another year before rapid export gains can be expected. An exception is Mexico, which already has boosted foreign exchange earnings significantly as a result of expanded tourism and border sales.

In fact, the current account positions of the key LDCs have improved to the point where, with normal direct investment and trade credit flows, they would need little or no net new bank borrowing. Argentina, Chile, Mexico, and Venezuela have current account positions ranging from a small deficit to a surplus. If they now were receiving a normal inflow (or even no outflow) of direct investment and trade credits, they would not need to borrow any net new funds from banks. Similarly, Brazil, which now has a current account deficit half that of 1982, would have to increase its outstanding debt by only 5 percent.

Under phase II conditions, however, the capital flows are not normal. Indeed, the significant current account improvements are being offset or exceeded by a continuing short-term capital drain. These outflows may even be exceeding new loans that are being provided by banks on an involuntary basis—through arrearages and IMF funding packages. Financial markets remain nervous especially with austerity-related political tensions expected to remain high within LDCs for many months. Because of the continuing austerity, the chances have increased that an LDC might take unilateral action to reduce its debt burden. In addition, the leverage that banks have over LDCs has decreased with the reduced LDC need for new loans. It will take many months of LDC financial and political stability to renew confidence in the financial future of these countries. Until then, short-term capital outflows could still overwhelm the fundamental gains, thereby creating a new financial crunch, reducing imports further, and postponing the day when lender confidence is restored.

Financial Confidence Begins To Be Reestablished and LDC Economic Recovery Starts

During this period, which could start in late 1983 at the earliest, the LDC current account position would continue to be sound (or improve somewhat), export growth would gain momentum, the short-term capital drain would end, and creditor confidence would begin to revive. Although key LDCs would still face considerable financial constraints, creditors would see that these countries are at or near the point that they could meet their rescheduled debt obligations. Faith in the long-term economic potential of these countries would surface once again. As a result of this increasingly favorable environment, lenders would be inclined to *voluntarily* refinance or roll over existing debts as they come due and would cautiously extend new loans.

The current account gains achieved in phases I and II would remain intact as rising exports would permit imports to begin to move up from their low point. In some cases, such as Brazil, imports would probably rise somewhat slower than exports to allow for sufficient funds to repay emergency loans and to rebuild

The timing of the decline in imports and domestic economic activity in each of the five key countries has varied considerably:

***Argentina** was the first to run into serious problems. Mainly because of increased government budget deficits, Buenos Aires had to cope with mounting payments problems in late 1980. The result was a sharp decline in imports (see figure) which was immediately followed by a drop in economic activity. An austerity program initiated in late 1981 restored stability to Argentine foreign exchange markets in early 1982, but soon the Falklands conflict weakened the country's external accounts as a result of faltering exports, capital flight, and the cessation of new lending. By midyear Argentina's real GNP had fallen some 15 percent and industrial production about one-third from the 1980 level. Recovery in both output and imports began in the second half of 1982 although it was held in check by a short-term capital drain caused by domestic political uncertainties and the global debt crisis.*

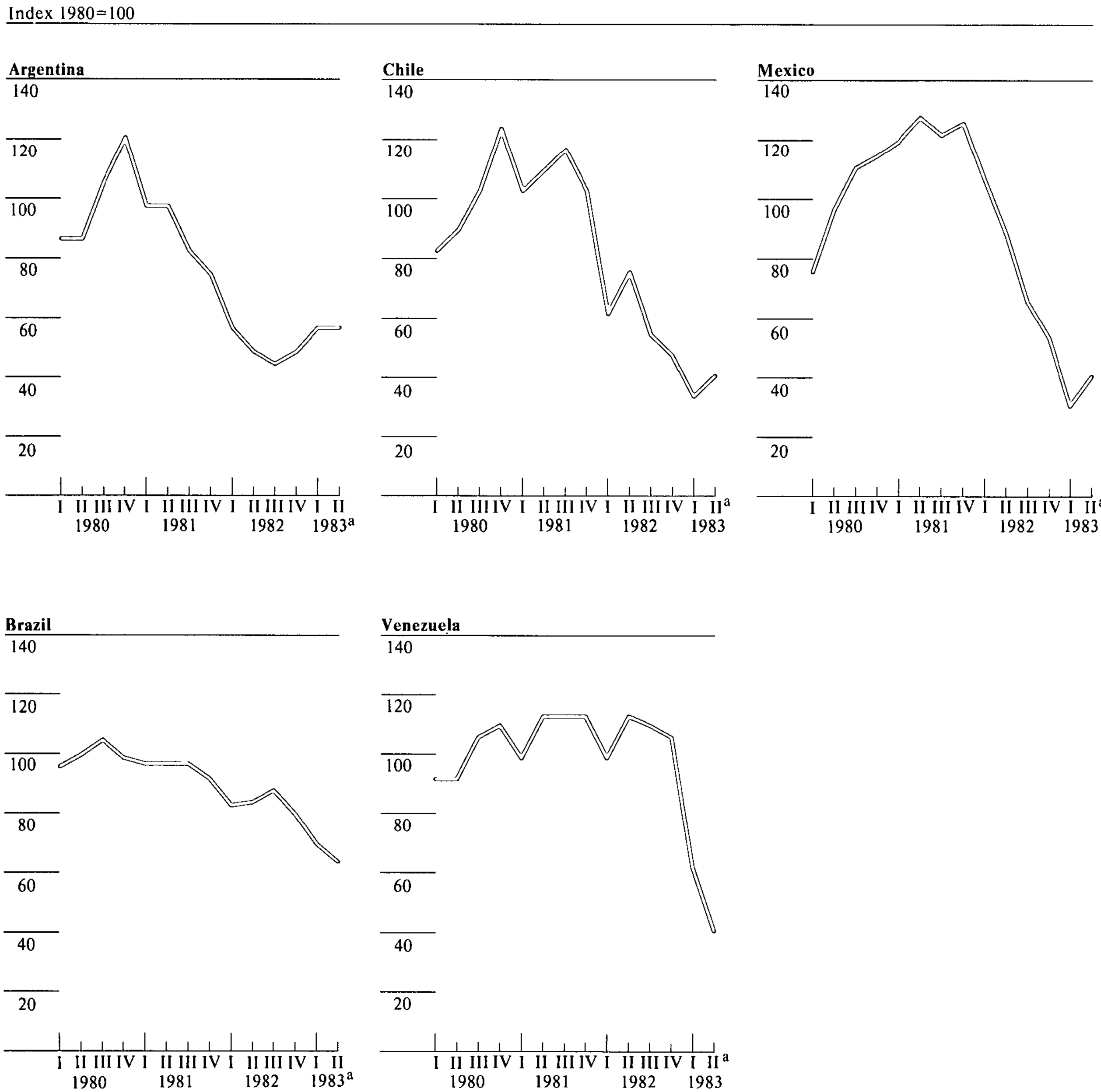
***Chile's** economic and import plunge began in late 1981, sparked mainly by faltering exports and a highly overvalued currency. Austerity measures soon introduced added to the economic woes, and the worsening international climate caused a further sharp falloff in imports and economic activity in the second half of 1982. By early 1983 the country's economy seemed to have bottomed out with GNP some 15 percent and industrial production more than 40 percent below the level of the first half of 1981. Unemployment meanwhile more than doubled, to more than 25 percent.*

***Mexico** has had to cope with the sharpest and most concentrated fall in imports and economic activity so far. The government initiated import controls in late 1981 and devaluated the peso in February 1982. These moves began to take hold in the first half of 1982. But, because of increasing government outlays, the domestic economy was still growing, although industrial production was stagnating. Then, during the six months following the August 1982 crisis, both imports and output fell off dramatically. Industrial activity fell some 20 percent, while construction plunged 75 percent. Unemployment doubled, reaching the 20- to 30-percent range. Much of the decline reflected the sudden and sharp decline in imports, which was greatly exacerbated by an 80-percent decline in the official value of the peso since early 1982 and by the need to impose foreign exchange controls for the first time in modern history. Until an exchange control bureaucracy could be put in place, import delays mounted. The nadir of import levels and economic activity was probably reached in the spring of 1983.*

***Venezuela's** foreign financial problems grew in 1982, reaching crisis proportions in early 1983. Falling oil revenues, poor debt management, and massive capital flight led to a mid-February devaluation of the bolivar and to the imposition of exchange controls for the first time in 20 years. Imports plummeted in the first half of 1983, and economic activity most likely fell considerably, although quantitative data is not yet available.*

***Brazil's** external and domestic economic trends have differed markedly from the other five key LDCs. Its imports and domestic activity declined much more gradually and over a longer period. Brazil implemented austerity measures in late 1980, and soon thereafter both indicators began to decline. Between then and late 1982, real GNP fell some 5 percent. This comparatively small decline reflects mainly the continuing attempt of Brasilia to balance its foreign and domestic problems by taking just enough austerity measures to satisfy foreign creditors. In the wake of the Mexican crisis, conditions began to deteriorate badly, resulting in a steeper decline in imports and forcing Brazil to introduce harsher austerity measures. Because of the prolonged discussions with the IMF and the resulting financial uncertainties, imports may have dropped particularly sharply around midyear, although we do not yet have any data.*

Key LDC Import Trends



[a] Estimate based on partner country trade

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foreign exchange reserves. In Argentina, Mexico, and Chile, imports might climb faster than exports because the decline in imports was so steep that the current account improvements were unnecessarily large. In addition, the key LDCs probably would need less of an increase in imports to feed their economic expansion than had been the case before the debt crisis. During the first two phases of the crisis, LDCs probably increased their self-sufficiency as producers and consumers, out of necessity, turned to domestic sources of supply.

At the same time, the key debt-laden LDCs would begin to show signs of economic recovery. Although the initial growth would be boosted mainly by increased exports to the industrial world, a number of domestic factors also would play a role. Domestic producers would find ways to operate more effectively under financial constraints, and governments would have relaxed and simplified the controls they imposed after the initial crisis. In addition, the sharp decline in economic activity in 1982 to 1983 would have sowed the seeds of economic recovery. Consumers, having postponed purchases, would have a pent-up demand. Firms, having pruned their costs of business, would be in a better position to compete. One sign of future confidence that already has emerged in Mexico and Brazil is the rebounding of the local stock market.

Although the momentum of this recovery may not bring back the economy to its earlier peak level for many months, it would help reinforce confidence in the country's economic abilities and heighten expectations about future gains. Similarly, the LDC's inflation rate would probably decline, although it would still remain high, mainly because of the continuing impact of the country's currency devaluations. These improving economic trends would help relieve social tensions.

Manageable Foreign Financial Positions Are Restored

As a result of constant improvements in their fundamental financial position and restoration of lender confidence, key LDCs could reach the point in 1984 or 1985 at which their foreign financial position would no longer severely bind economic expansion. A major factor in this improved financial condition would be the one-time large boost provided by a reversion of short-term flows to a normal pattern. A precrisis atmosphere would return whereby foreign financial constraints would again become a normal aspect of economic policymaking. In essence, these countries would have grown into their debt levels and structure and would be in a good position to gradually increase their debt level. Although scheduled debt repayments are likely to be particularly high in the mid-1980s, that situation is unlikely to force a new loan crisis under phase IV conditions. Experience during the 1970s indicates that bankers are inclined to reschedule loan payments to overcome such "bunching" when the financial climate is favorable. Creditors would see expanding opportunities to provide profitable and reasonably risk-free loans because of rising LDC foreign exchange earnings. In fact, the "spreads" (difference between the cost of money and the amount charged) that banks are able to obtain from LDCs would probably fall more slowly than the risks assumed, making the loans exceedingly profitable.

The highly unusual circumstances that led to a 20- to 40-percent annual rise in outstanding loans between 1979 and 1981—soaring oil prices and the large jump in interest rates—are unlikely to be repeated. In the absence of such problems, an increase of 5 percent a year or so in the real level of loans would probably be adequate to foster the economic expansion of key LDCs. This last phase of the credit crunch cycle is likely to end with little fanfare. As with most fading problems, little attention will be paid to them.

The Importance of Short-Term Capital Flows

Shifts in short-term capital flows have been a major factor in forcing the sharp import decline and thereby accelerating the adjustment process. Because they are highly sensitive to changes in confidence in a country's foreign financial position, these volatile flows have acted to greatly exaggerate the adjustment process, pushing it beyond what probably took place under LDC government programs aimed at pruning imports directly by import and foreign exchange controls, and indirectly through currency devaluations and cuts in budget outlays and real wages. When

confidence is waning, the shift in short-term capital movements influences imports directly by reducing new trade credits and indirectly by curtailing the amount of foreign exchange available to buy foreign goods and services. In both cases, the most damage to the country's import capabilities occurs in the early months of the crisis, although the short-term capital drain is likely to continue well into phase II at a much reduced rate. Once financial confidence in the troubled LDC begins to be restored in phase III, the inflow is likely to turn positive, and this favorable shift will be an important element in improving the foreign financial position of the key LDCs.

Although the powerful influence of short-term capital flows is recognized by most experts, it is given little attention. Most economists tend to look at the medium-term adjustment process and use annual data that do not capture the significance of short-term capital flows. In large measure, this concentration on the medium-term changes reflects the paucity of short-term capital data. They are virtually nonexistent during the crisis period, and data that do become available after the fact are meager. Perhaps the best way of understanding the nature and magnitude of these large shifts in short-term capital flows is to look at the groups that, out of the natural instinct to protect themselves from possible financial losses, are creating the flows.

Commercial banks want to reduce their exposure in the troubled country. They have done so primarily by cutting back on the short-term credit lines, by not renewing credits once paid, and by drawing down any deposits they may have with banks of the troubled nation. In Argentina and Mexico, outstanding short-term credits provided by foreign commercial banks dropped some 10 to 20 percent in 1982. In Brazil and Venezuela, the data available through the end of 1982 show little change in the outstanding amount of short-term bank credits, but that probably changed as the financial troubles of these countries mounted in 1983. More recently, because of the growing possibility of a Brazilian debt moratorium and the likelihood that such a move would result in short-term debts being rolled up into a medium-term repayment schedule, foreign creditors are curtailing such credits. Brazil has been partially offsetting such losses by delaying payments on outstanding credits. For countries with fairly large regional trade, such as Brazil, however, their short-term capital position has been adversely affected by delayed payments from countries that also are strapped financially.

Even if more data were available on short-term bank debts that are outstanding, the numbers could not adequately portray the impact short-term flows are having on imports. They essentially reflect how much the banks are able to reduce their short-term exposure to the troubled country on *previous* loans. In most cases declines in these outstanding amounts are being limited by LDC central bank actions aimed at avoiding further losses of foreign exchange. The missing statistic is the cutback in *new* loans. Such reductions are forcing the key LDCs to pay cash for their foreign purchases. The major impact of this sudden shrinkage in new import credits is felt in the first three to six months of the country's financial crisis with the timing depending on the average length of normal credits.

Foreign bank withdrawals of deposits from LDC banks have mainly affected Brazil. In that country, deposits were reduced by some $4 billion between mid-1982 and mid-1983. Although theoretically the outflow could continue until all these funds are withdrawn, an agreement between the IMF, the Brazilian Government, and commercial banks seems to have slowed the drain. As of July 1983 there was still $6 billion deposited with Brazilian banks.

Suppliers of goods and services want to ensure they are paid for new sales. Foreign exporters have sharply reduced the 90- to 120-day short-term loans and open account credits they normally provide Latin American countries, thereby forcing the importer to pay via a confirmed letter of credit or to pay cash. The reduction in these nonbank credits probably had a larger impact on restraining imports than did the reduction in short-term bank loans. US Commerce Department surveys indicate that more than half of the US goods sold to Latin American countries involve (nonbank) suppliers credits. In Mexico and

Venezuela that percentage probably was even higher because the free movement of foreign exchange in and out of these countries (until recently) had greatly facilitated direct commercial relations between suppliers and buyers. As with short-term bank credits, although the data are limited,[2] the drying up of new supplier credits probably had its major impact on imports in the first six months of the crisis. For example, between August 1982 and early 1983, Mexico probably lost some $5 billion in new supplier credits. In Venezuela, according to the US Embassy, after the early 1983 financial crisis, low-credit-risk companies that used to make 90 percent of their foreign purchases on open accounts and 10 percent on confirmed letters of credit have seen these percentages reversed.

Multinational companies and other foreign investors want to avoid having their assets in the LDC frozen or even nationalized, want to maintain the flow of profits, and want to prevent financial losses incurred by holding a rapidly depreciating local currency. They have done so by cutting foreign exchange loans provided their subsidiaries and by not shipping goods to their subsidiaries unless they pay in dollars or in other convertible currencies. In the same vein, multinational firms have stopped providing guarantees on bank loans made to their subsidiaries. Sometimes, however, the foreign investor has decided that, to keep its subsidiary in business, it has to supply needed goods on credit. These companies also have sharply cut back on using foreign funds to provide equity financing. Any new investments being made are from retained earnings in the country or are based on local currency loans. Finally, investors are trying to accelerate the outflow of profits earned by their local subsidiary. All these moves force the subsidiary to turn to the country's central bank for its foreign exchange needs and to the local market for a higher portion of goods and services used in its operations.

[2] A US Government series that partially covers suppliers credits (commercial claims of US nonbanks) shows the amount outstanding to the five key LDCs declined more than 40 percent between the end of 1981 and end of 1982.

Residents of the LDC want to ensure that they have sufficient assets abroad in case the economic troubles at home seriously hurt their financial position or in case they want to leave the country because of political reasons. Individuals and companies have moved funds out through currency black markets that always develop when international currency transactions are not freely permitted by a country. In addition, firms resident in LDCs (local or foreign) have increased their foreign exchange holdings abroad by underinvoicing the value of their exports and overinvoicing their imports. In the case of multinational firms and individuals, no data exist on short-term capital flows. Most of these movements show up in residual categories of the balance of payments such as errors and omissions and short-term capital flows, not elsewhere classified. It usually takes a year or so after the fact before data are available even in the case of these ambiguous categories.

The Timing of the Process

With their current account position now reasonably sound, the speed at which the key LDCs reach phase IV will depend heavily on their ability to avoid circumstances that upset the restoring of financial confidence (assuming the industrial-country recovery is sustained). That ability centers on the difficult task of containing domestic political tensions that are resulting from economic dislocations, rising unemployment, and a reduced standard of living. If all goes reasonably well, these key LDCs could achieve a manageable foreign payments position by 1984. If the path is particularly rocky the agony could last into 1985.

No matter how difficult, the movement toward phase IV is likely to be sustained because of the market pressures described above, the common interest of both lending and borrowing countries in securing such a result, and the demonstrated ability of all parties involved and the international financial system to cope with debt-related problems. Industrial countries,

Table 2
US Exports to Select LDCs

Million $

	January Through May	
	1982	1983
Argentina	682	412
Brazil	1,450	958
Chile	382	269
Mexico	5,993	3,593
Venezuela	2,103	1,150
Total	**10,610**	**6,382**
South Korea	2,118	2,288
Taiwan	1,820	1,683
Hong Kong	1,016	1,052
Total	**4,954**	**5,123**
All countries	92,925	83,022

and especially the United States, have a major stake in promoting healthy economies in the five Latin American LDCs in order to avoid political upheavals there and to provide growth markets for exports. US exports alone dropped more than $4 billion in the first five months of 1983 as a result of reduced imports by the five major debt-laden Latin American countries. (See table 2.) The major commercial banks want to protect their sizable assets in LDCs and would like the LDCs to remain as major profit centers. The key LDCs want to stay creditworthy to ensure a continuing flow of new loans and to avoid a legal default, which their leaders now believe would produce even greater hardships than at present.

The key LDCs have demonstrated an economic vitality for two decades and have amassed considerable experience in handling political-economic difficulties, a factor that stands them in good stead for coping with present problems. Their domestic political stability has been greatly strengthened by a rising middle class that has a vital stake in avoiding political upheavals. For the most part, the elite of these countries understand the benefits of close economic links with the industrial world and the need to sustain the growth of foreign exchange earnings. Although key LDC governments often have voluntarily taken the necessary corrective steps to maintain a positive foreign exchange position, when they did hesitate, a rapidly deteriorating foreign payments position forced them to take remedial action.

The major commercial banks believe they can continue to profit handsomely from a prudent expansion of their LDC lending. Explicitly or implicitly, many commercial bank officials see the risks involved in lending to LDCs as low as or lower than domestic loans, because they believe that central banks would not stand by and allow major commercial banks to fail and the international financial system to be disrupted by a default by one or more major LDCs.

Despite these strengths, there are a number of factors that could undermine the rebuilding of confidence in the financial capabilities of the key LDCs and thereby prolong the corrective process and make it more painful. For example, the deepening austerity and resulting political discontent within LDCs are likely to make the leaders of some key LDCs take a more nationalistic stance. As a result, these leaders might oppose further IMF constraints or do little to meet the already agreed-to targets. The IMF, meanwhile, probably would not want to relax the economic and financial constraints placed on the reluctant LDC because other countries would demand similar treatment. Although some compromise is likely to be reached between the LDC and the IMF, the reestablishment of financial confidence could be delayed several months. The uncertainty during that time would further hurt the economy of the LDC. Imports would have to be cut again because the short-term capital drain caused by the fears of lenders would reduce the foreign exchange available for imports. A similar circumstance could occur even if there is no dispute between the LDC government and the IMF. Incessant political dissension in an LDC, for example, would make the international financial community apprehensive as to the ability of the nation's leaders to maintain their grip on power.

Although confidence-shaking events present a significant risk in all five key LDCs, **Mexico** has the best chance of moving the fastest toward phase IV. It has

digested a highly concentrated dose of austerity and economic disruptions in a relatively short period and is now ready to rebound. By year's end Mexico could have a manageable foreign payments position, a reasonable rate of economic recovery, and, most important, a return of confidence in the country's economic and financial future on the part of both Mexicans and foreigners. These factors, in themselves, would help contain political dissension. From a financial point of view, **Argentina** and **Chile** are poised to achieve manageable foreign payments positions within a year. Both, however, face a significant risk of political upheavals. **Venezuela** may soon begin the recovery process and probably has less chance of political upheavals than either Argentina or Chile. It, however, will go through a period of political uncertainties until a new or reelected president takes office in March 1984. To add to the factors that could undermine confidence, the incumbent President, Luis Herrera, is reluctant to accept an IMF adjustment program. **Brazil** probably faces the most significant political and economic uncertainties that could delay the restoration of foreign financial confidence. Several more months of sharply reduced imports and declining economic activity seem likely. This prolonging of Brazil's long-suffering economy could be particularly unsettling. Moreover, domestic political tensions are likely to build with the move toward democracy and the absence of President Figueiredo for health reasons.

If the process of resolving the debt crisis during phase II is prolonged, it might follow the pattern described below:

- Key LDCs declare an indeterminate moratorium on debt-service payments (both principal and interest).

- Industrial-country governments (supported by commercial banks) respond by providing emergency funds to LDCs designed to promote political stability and arrest the fall in imports. The aid also is intended as a quid pro quo for LDC governments to begin debt negotiations and, hopefully, to resume paying some debt obligations.

- After several months of negotiations, new austerity/debt-relief accords are reached. Although the accords are likely to be tailored to meet the special circumstances of each LDC, the chances will increase that one of many comprehensive international debt-relief schemes surfacing in recent months would be put in place. Most of these proposals involve creating a new international arrangement that would stretch out debt-service payments and provide a guarantee that the bulk of the currently outstanding debt would be repaid eventually.

- After new agreements are reached, it might take another six months to restore sufficient confidence in LDC financial capabilities to end phase II. The lower import level and stretched-out debt resulting from the new crisis would improve LDC financial fundamentals and thus help reduce the time until confidence is restored. Whether an international refinancing scheme would help shorten phase II or prove counterproductive depends on how the commercial banks view the accord. If, for example, bankers believe that the new arrangement provides greater incentives to LDCs to seek future debt relief, they would be less inclined to provide new loans.

Besides an abridged industrial-world recovery, the adjustment process could be sidetracked if one (or more) of the key LDCs repudiates its debt or, more likely, declares an indeterminate moratorium on debt servicing. Such moves would quickly end the debt problems of the LDCs taking the action but would cause serious economic and financial problems for both developed and less developed countries. Such possibilities could be triggered by the following circumstances:

- Within the LDCs, as a result of austerity or other domestic problems, political pressures could build to a point where a country's leaders come to believe their survivability is best served by a default and by blaming outsiders for their country's plight.

- Outside the LDCs, a relapse of the world economy into another recession during the next two to three years also could, as a result of reduced exports, force domestic austerity that would be politically painful.

- In the same vein, the flow of new commercial bank lending to key LDCs might be sharply curtailed as a result of new laws or tightened financial regulations in developed countries. Again, the result could be that LDC austerity reaches a politically unpalatable level.

Political-Economic Ramifications of a Prolonged Phase II

Foreign financial setbacks that would lengthen phase II would most certainly heighten economic pain. During the past 18 months the five key LDCs have faced the sharpest declines in real GNP in more than 30 years (the exception being Chile in 1975). Such additional financial problems would probably arrest the recoveries just becoming evident in Argentina, Chile, and Mexico. They might even cause a renewed downturn. The declining economic activity now in train in Brazil and Venezuela would be sharply deepened. As a consequence of the setback in foreign confidence, the currencies of the key LDCs would weaken, adding to an inflationary rate that already has reached exceptionally high levels. The need to cut imports again would further add to these inflationary pressures. Living standards would decline, and, most important, expectations as to improvements ahead would dim.

While these economic hardships and the increased pessimism cannot be translated into political consequences with any degree of certainty, it seems that, at a minimum, these impacts would lead to heightened nationalism with anti–First World overtones and, at a maximum, to new regimes that initiate strong populist policies that hurt US interests and seriously undercut the informal codes of international behavior that have been important in avoiding global depressions since World War II. So far, despite the unprecedented economic distress faced by these LDCs, their governments have continued to play by these informal rules of behavior. For example, no LDC has yet reneged on its debt obligations for financial reasons, a fairly common event prior to 1940. In large part, as mentioned earlier, this adherence to the rules represents a sense among the leaders of the key LDCs that the countries' self-interest is best served by working out the problems with the developed countries and within the framework of international institutions such as the IMF.

The prolonged economic agony would probably lead, at first, to a resurgence in deep-seated Latin American nationalism spurred on by organized labor and leftist groups. These domestic pressures would make the governments much less inclined to agree to new austerity measures and to cooperate with the United States on other issues. The legitimacy of the current government regimes might even be questioned. While regime changes cannot be predicted, clearly the risk of such an event would increase significantly. If new regimes come to power, they are likely to have a strong nationalistic and populist bent. If the current regimes survive, they might do so by being more repressive at home, a factor that could make the country more politically unstable in the medium term. A more extensive treatment of these political consequences will be presented in the forthcoming NIE 3-83: *Medium-Term Repercussions of the Debt Problem in Key LDCs.*

Some Policy Implications

- The debt crisis will be resolved in one fashion or another and probably in a shorter period than indicated by many observers. The real problem now facing policymakers is how to make the corrective process as painless and as short as possible.

- To keep the process from stalling, financial confidence in the key LDCs must be restored and maintained. To do so, it may require paying more attention to ensuring that sufficient liquidity is provided to the few "super" LDC borrowers. Al-

though LDCs must also accept IMF-imposed corrective goals in order to help rebuild lender confidence, meeting these targets fully now is less important than sustaining adequate liquidity. With the political situation fragile, any new disturbance could boost short-term capital outflows and prolong the political and economic agony.

- Industrial-country governments would have to take the lead in ensuring adequate liquidity for LDCs. A number of schemes are possible; for example, developed countries could guarantee that the trade financing provided LDCs is repaid or could establish a large enough fund (perhaps $10 billion to $15 billion in the Brazilian case) to assure creditors and others that the LDC would have sufficient foreign exchange to meet its foreign obligations.

- Whatever the scheme, it would entail achieving a delicate balance between sustaining sufficient lender confidence to prevent a large short-term capital outflow and avoiding the possibility that the financial "guarantee" would encourage even greater outflows. The "guarantee," especially at first, might induce lenders to reduce their outstanding obligations and those with assets in LDCs to move them abroad. Only when it became clear that sufficient foreign exchange was available to meet the demands of all would the drain be fully halted.

- The pace of industrial-country economic recovery will continue to play a vital role in moving, as rapidly as possible, toward phase IV—the last phase in the debt-crisis process.

- From the viewpoint of the United States and other industrial countries, their trade position with LDCs is likely to continue to be poor and may even deteriorate in some cases as LDC imports are held in check and their exports grow.

- Some moves by industrial-country governments to reshape the international financial system in order to prevent similar future debt crises could be harmful—for example, much tighter regulations on foreign lending activities. The current crisis stems from a unique set of circumstances that are highly unlikely to be repeated. Such corrective moves could hinder what now seems to be a highly flexible and resilient international financial system.

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